

Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-08 FRB-03
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TO SECSTATE WASH DC 6918
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PASS FRB

E.O. 11652/ N/A
TAGS/ EFIN, IT
SUBJECT: FINANCIAL MARKETS' REACTION TO DISCOUNT RATE REDUCTION
AND PROPOSED NEW TAX TREATMENT OF DIVIDENT INCOME:
"PRIME RATE/ CUT

REF/ A. ROME 13989, B.ROME 14249, C. ROME 10279

1. MARKET CONSEQUENCES OF THE DISCOUNT RATE REDUCTION
AND PROPOSED TAX CHANGES (REFS A AND B) HAVE WORKED OUT
AS EXPECTED: THE INTERBANK RATE ON 3 MONTH AND 24 HOUR
DEPOSITS IMMEDIATELY DROPPED ON PERCENTAGE POINT TO 13
AND 12.4 PERCENT, RESPECTIVELY, AND STOCK PRICES ROSE ON
AVERAGE ABOUT 9 PERCENT. SHORT-TERM INTEREST RATES, INCLUDING
THE KEY TREASURY BILL RATE, HAD ALREADY DECLINED SUB-
STANTIALLY FROM MARCH LEVELS OF ABOUT 17 PERCENT, AND THE
STOCK MARKET HAD ANTICIPATED BY ABOUT A WEEK THE PROPOSED
ELIMINATION OF DOUBLE TAXATION OF DIVIDEND INCOME.

2. ON SEPTEMBER 1 THE EXECUTIVE COMMITTEE OF BANKER'S
ASSOCIATION DECIDED ON LOWERING THE "PRIME RATE"
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FROM 18.5 TO 17 PERCENT ON UNSECURED LOANS, I.E.,
BY THE SAME AMOUNT AS THE DISCOUNT RATE REDUCTION,
AND FROM 18 TO 17 PERCENT ON SECURED LOANS. THE "PRIME
RATE" HAD MOST RECENTLY BEEN LOWERD IN JUNE FOLLOWING
THE PREVIOUS DISCOUNT RATE REDUCTION (REF C). IT IS
EXPECTED THAT, ON THE "RECOMMENDATION" OF THE EXECUTIVE
COMMITTEE OF THE BANKING ASSOCIATION, BANKS WILL ALSO

REDUCE RATES ON DEPOSIT BY ABOUT A PERCENTAGE POINT.
AN IMPORTANT FACTOR, HOWEVER, IN DETERMINING THE
RATE OF RETURN ON SAVINGS IS THE YIELD ON TREASURY
BILLS, WHICH IS NOT SUBJECT TO INCOME TAX. AT THE
MOST RECENT AUCTION IN AUGUST (SEPTEMBER), THE YIELD ON
3 MONTH BILLS WAS 14.13 PERCENT.

3. DIRECT CREDIT CONTROLS ON BANKS IN THE FORM OF
PORTFOLIO INVESTMENT REQUIREMENTS AND CEILINGS ON
THE EXPANSION OF LIRA LOANS ARE DISTORTING FACTORS, HOWEVER,
IN THE ITALIAN FINANCIAL MARKETS. THE CONTINUATION OF THESE
CONTROLS MEANS THAT MARKET RATES OF INTEREST IN ITALY DO
NOT FULLY REFLECT UNDERLYING SUPPLY AND DEMAND CONDITIONS.

4. ITALY'S HEAVY SHORT-TERM FOREIGN INDEBTEDNESS CONSTITUTES
AN INHIBITING FACTOR ON HOW FAR INTEREST RATES CAN COME
DOWN IN ITALY. AS OF THE END OF JUNE, THE NET FOREIGN INDEBTED-
NESS OF ITALY'S COMMERCIAL BANKS (ALL SHORT-TERM) WAS
\$7.2 BILLION. AT PRESENT THE UNCOVERED INTEREST
DIFFERENTIAL BETWEEN SHORT-TERM RATES IN THE EURO-
DOLLAR MARKET AND ITALY IS ABOUT 6.5 PERCENTAGE POINTS IN
FAVOR OF BORROWING ABROAD. IF THE DISCOUNT ON THE LIRA
IN THE FORWARD EXCHANGE MARKET IS TAKEN INTO ACCOUNT,
HOWEVER, THERE IS NOW AN INCENTIVE TO BORROW DOMESTICALLY.
SHOULD ITALIAN INTEREST RATES DECLINE TOO MUCH RELATIVE TO
RATES ABROAD, A SUBSTANTIAL REVERSAL OF SHORT-TERM CAPITAL
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FLows COULD OCCUR, WHICH WOULD EXERT DOWNWARD PRESSURE
ON THE LIRA IN THE EXCHANGE MARKET. (BANK OF ITALY
GOVERNOR BAFFI TOLD TREASURY ATTACHE DURING THE RECENT
COURTESY CALL THAT THE BANKS HAD BEGUN TO REDUCE THEIR
NET FOREIGN DEBTOR POSITION. MONETARY MOVEMENTS DATA
SHOW A REDUCTION IN THE BANK'S NET FOREIGN INDEBTEDNESS
BY \$260 MILLION DURING AUGUST 1-15.)

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Message Attributes

Automatic Decaptioning: X
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Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 22 May 2009
Disposition Event:
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